

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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NO INFORMATION RECEIVED
Release copies to District
Date
Surname

Date: AUG 31 2001

Contact Person:

ID Number:

Telephone Number:

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated as a Not-for-Profit entity under the Laws of the State of [REDACTED] on [REDACTED]. Your articles of incorporation include language that sufficiently limits your activities to purposes described in section 501(c)(3) of the Code. However, your articles do not dedicate your assets, upon dissolution, to another organization exempt from federal income taxation under section 501(c)(3) of the Code.

Your articles of incorporation provide that your first Board of Trustees includes: [REDACTED], [REDACTED] and [REDACTED]. Your articles also name [REDACTED] president; [REDACTED] executive vice president; [REDACTED] vice president; [REDACTED] vice president / secretary; [REDACTED] vice president / asst. secretary; and [REDACTED] asst. secretary/ treasurer.

You seek to provide education and instruction to public school children in [REDACTED] through the operation of a charter school. You plan to construct a school facility in the [REDACTED] community, a new residential community currently under construction. [REDACTED] (a for-profit company, prepared and submitted your charter school application to the [REDACTED] School District in [REDACTED] and received approval on [REDACTED]. [REDACTED] is the owner of the land and is related to the construction company developing the community. All members of your board of directors are owners, directors or employees of [REDACTED]. The same individuals structurally and functionally control both you and [REDACTED].

[REDACTED]

Promotional material advertising [REDACTED] a housing development, found on its Internet web page states:

"Better yet, [REDACTED] offers an exceptional opportunity for families: its own charter school. The [REDACTED] will provide education for students in Pre-Kindergarten and Kindergarten through eighth grade. Enrollment for classes begins the [REDACTED]

In conjunction with the residential development, [REDACTED] may be required to enter into an agreement with the County for the payment of an amount of money ("impact fees") to be utilized to meet the educational needs of the future residents of the platted area. [REDACTED] is creating the charter school to obtain credits to be applied to any impact fees assessed by the County.

You and [REDACTED] are both principles to a Development and Planning Agreement ("D&P agreement") executed with [REDACTED] ([REDACTED]). Generally, the DPA gives control of your activities prior to opening of your school to [REDACTED] and [REDACTED]. You have contracted away virtually all of your activities to [REDACTED] and [REDACTED]. You have little, if any, control over basic activities such as the negotiation of your charter contract with the Chartering Entity or the coordination, negotiation and administration of contracts entered into by you for necessary services performed by third parties.

Direct responsibility for the operation and management of your school is undertaken in accordance with a management agreement ("agreement") with [REDACTED] through its subsidiary, [REDACTED] at [REDACTED]

[REDACTED] and you have executed the agreement but it is very apparent that [REDACTED] was intimately involved in the drafting. The Recitals of the agreement state:

"WHEREAS, [REDACTED], a [REDACTED] corporation (the "Applicant") has filed an Initial application for the grant of a charter (the "Charter") for the School Board of [REDACTED] (the "Chartering Entity") to operate as a charter school; and
WHEREAS, Applicant has determined that it is in its best interest to open a charter school to operate as a separate not-for-profit corporation; and
WHEREAS, Applicant has created Charter School to operate the permitted charter school under the Charter ..."

The agreement with [REDACTED] is comprehensive in nature and provides that [REDACTED] will assume full responsibility for the education of your students. Similar to the control given to [REDACTED] and [REDACTED] in the D&P agreement for pre-opening operation, the agreement gives control over virtually all of your on-going activities to [REDACTED] and [REDACTED]. [REDACTED] is responsible to plan, implement and oversee a curriculum for you, student recruitment and enrollment. Your principal, faculty and staff will be employees of [REDACTED]. [REDACTED] will perform all your accounting and financial management including maintaining your Operating Account with signature authority.

[REDACTED] is responsible for such basic educational activities as the coordination and oversight of all organized parental involvement, including the required participation of parents of your

students. [REDACTED] will also establish and work with any parent-teacher organization. [REDACTED] has authority over all official public relations for you, including community outreach, press releases, and media relations.

You agree to compensate [REDACTED] 14% of your school revenues for its management services. School revenues are defined as gross revenues from any source including, but not limited to, funding by individuals and private corporations, government funding and any grants obtained (whether by individuals, private corporations or government entities).

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(b)(1) of the regulations generally provides that an organization will be regarded as organized exclusively for one or more exempt purposes only if its articles of incorporation (1) limit its purposes to exempt purposes and, (2) do not expressly empower it to engage in activities which are not in furtherance of exempt purposes.

Section 1.501(c)(3)-1(b)(4) of the regulations provides that an organization is not organized for exempt purposes unless, upon dissolution, its assets are dedicated to an exempt purpose.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides that the term "educational", as used in section 501(c)(3), relates to—

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

[REDACTED]

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 179, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes:

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973).

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree.

To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to EST, Inc., and it further controls petitioner's operations by providing management personnel who are paid by and responsible to EST, Inc. In short, petitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc. Moreover, we note that petitioner's rights vis-à-vis EST, Inc., International, and PSMA are dependent on the existence of its tax-exempt status—an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status...

Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefitted substantially from the operation of petitioner, (Emphasis added).

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court was called on to decide whether benefits to third parties, who were not members, would prevent the organization from being recognized as an exempt organization within the meaning of section 501(c)(3) of the Code. The Court concluded that the organization could not confer substantial benefits on disinterested persons and still serve public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Secondary benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose. Indeed, such a

construction would cloud the focus of the operational test, which probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

In Redlands Surgical Services, v. Commissioner, 113 T.C. 47 (1999), the Tax Court held that a nonprofit wholly owned subsidiary of Redland Health Systems (a 501(c)(3) organization) operated for impermissible private benefit when it ceded effective control over partnership operations to private parties who had no requirement to operate exclusively for purposes described in section 501(c)(3). The organization's sole activity was participating as co-general partner with a for-profit corporation in a partnership that owned and operated an ambulatory surgery center. An affiliate of the for-profit partner was the manager of the surgical center. It received a 6% management fee under the management agreement. The court closely examined the structure of the relationships among the parties and stated:

Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purpose in engaging in it. An organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes." Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), affd. T.C. Memo. 1990-84. The binding commitments that petitioner has entered into and that govern its participation in the partnerships are indicative of petitioner's purposes. To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes...nothing in the General Partnership agreement, or in any of the other binding commitments relating to the operation of the Surgery Center, establishes any obligation that charitable purposes be put ahead of economic objectives in the Surgery Center's operations. The General Partnership agreement does not expressly state any mutually agreed-upon charitable purposes or objective of the partnership.

The court also looked closely at the governing arrangement of the partnership. It likened it to a board of directors. The court stated that the composition of the board of directors gives an indication of whether the organization is operated for public or private purposes. The court quoted with approval from "Income Tax Exempt of the Contemporary Nonprofit Hospital", Mancino, 32 St. Louis U.L.J. 1015, 1051 (1988).

[REDACTED]

The board of directors, its composition, and its functions are relevant to tax exemption...the composition of the board provides important evidence that the hospital serves public rather than private purposes. For, example, it is fair to presume that a board of directors chosen from the community would place the interests of the community above those of either the management or the medical staff of the hospital. Thus, the relevance of the board is that its process should indicate whether the hospital is operated for the benefit of the community or to secure benefits for private interests.

After a through analysis of the all of the operating agreements entered into by the petitioner, the court reached the following conclusions.

Based on all of the facts and circumstances, we hold that petitioner has not established that it operates exclusively for exempt purposes within the meaning of section 501(c)(3). In reaching this holding, we do not view any one factor as crucial, but we have considered these factors in their totality: The lack of any express or implied obligation of the for-profit interests involved in petitioner's sole activity to put charitable objectives ahead of non charitable objectives, petitioner's lack of voting control over the General Partnership; petitioner's lack of other formal or informal control sufficient to insure furtherance of charitable purposes; the long-term contract giving SCA Management control over day-to-day operations as well as a profit-maximizing incentive; and the market advantages and competitive benefits secured by the SCA affiliates as the result of this arrangement with petitioner. Taken in their totality, these factors compel the conclusion that by ceding effective control over its operations to for-profit parties, petitioner impermissibly serves private interests.

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). You have included sufficient limiting language in your organizing document as to your purposes; however, your dissolution clause fails to dedicate your assets to other federal tax-exempt entities. You therefore fail the organizational test.

You must also satisfy the operational test. The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement is that an organization be operated exclusively for one or more exempt purposes. To determine whether this test is satisfied, section 1.501(c)(3)-1(c)(1) of the regulations directs the Service to determine if the organization engages primarily in activities which accomplish one or more exempt purposes. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes unless it serves a public rather than a private interest.

Your method of operating a charter school provides a substantial benefit to [REDACTED] and [REDACTED] for-profit organizations. The presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt

purposes. Better Business Bureau of Washington, supra. Based on the facts that you have provided in your application for recognition of exemption, we are not able to conclude that you are operated exclusively for public rather than private purposes.

The information you have submitted discloses that [REDACTED] created you. Your initial (and current) Directors consist of owners, directors or employees of [REDACTED]. While existing as a separate legal entity, you are effectively controlled by [REDACTED]. Your Board members, all [REDACTED] related, select new members of your Board of Directors and can remove any Director without cause. [REDACTED]'s ability to control your activities makes it impossible to determine if decisions made by your Board of Directors are for your benefit or for the benefit of [REDACTED]. It is clear that [REDACTED] plans to use your creation to reduce any impact fees it may be liable for concerning the development of a residential area. You will also be used to promote the new [REDACTED] residential development. It is clear that the presence of a new charter school is a major advertising advantage for [REDACTED].

Additionally, under several agreements with [REDACTED] to provide comprehensive services to you, impermissible control of your operations is given to [REDACTED]. For example:

1. [REDACTED], along with [REDACTED] will negotiate your charter agreement with the Chartering Authority. Thus, you have no ability to shape or control how your activities will be structured.
2. [REDACTED] is responsible for the implementation and administration of your curriculum and the administration of all extra- and co-curriculum activities and programs. You have no ability to determine how your students will be educated.
3. [REDACTED] is responsible for the selection and acquisition of all instructional materials, equipment, supplies and services required for operation of the school.
4. [REDACTED] is the employer of the administrators, faculty and staff of your school and has sole authority to hire, fire, and supervise the personnel.
5. [REDACTED] has responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. You have no control over any personnel who will be carrying out your educational mission.
6. [REDACTED] is responsible for all aspects of the business and financial administration of the school including signature authority of your bank account. Other than approval of a [REDACTED] prepared budget at the beginning of the year, you have no control over your revenues.
7. [REDACTED] is given responsibility to set up your marketing plan including parent orientation, student marketing and the preparation, management, supervision, and implementation of your school's opening.
8. [REDACTED] is given authority to perform any function necessary or expedient for the

[REDACTED]

administration of the school including binding you to contracts with third parties.

9. [REDACTED] is given approval rights to all official public relations communications.
10. [REDACTED] is given responsibility to establish and work with parent-teacher groups. You have retained little, if any, ability to create an identity for yourself by allowing [REDACTED] to act as a buffer between you and the people you are supposed to be serving: students, parents, teachers and the general public.

Contracting away such extensive control over your activities serves the private interest of [REDACTED] and precludes your exemption under section 501(c)(3) of the Code. [REDACTED] cannot be viewed simply as a third-party service provider. You have gone beyond contracting for services and entered a relationship that could be compared to a franchise or joint-venture. Your relationship with [REDACTED] does not allow you to develop independently as an organization and a school outside the management contract. Your contract requires little from you other than obtaining section 501(c)(3) tax-exempt status. You have entered into a relationship with [REDACTED] which, in effect, has allowed a for-profit entity to control a charter school. You have given up your ability to effectively operate after termination of the agreement by agreeing to the non-compete clause of the agreement. This severely hampers your ability to decide what is best for your children because you cannot terminate your management company without losing your curriculum and staff.

Your relationship with [REDACTED] is similar to the relationship discussed in est of Hawaii, supra. That case concerned a franchise arrangement in which the exempt organization purchased its programs and staff from for-profit entities. Although there was no structural relationship between the entities, the Court inferred from the totality of benefits flowing from the exempt organization to the for-profits that they had substantial influence over the non-profit's operations. The Court ruled that est existed for the benefit of the for-profit entities and could not be exempt. Similarly, you purchase use of an educational program, supplies, equipment, furniture and furnishings from [REDACTED]. You receive management, development, construction and financing services from [REDACTED]. You look to [REDACTED] to provide you with everything to operate a charter school except the charter itself. You are providing benefits that are in excess of the benefits provided by est of Hawaii.

Your case is also strikingly similar to the facts discussed in Harding Hospital, supra. That case concerned a contractual relationship between a non-profit hospital and an association of physicians. You give control over your students to [REDACTED] similar to the control over the patients given to the physicians. You give control of your per pupil revenue funding to [REDACTED] similar to the physician's control over the hospital patient revenue stream. Like the physician's supervisory activity fees, you compensate [REDACTED] over and above the per pupil funding, presumably for any and all services a school like yours would need.

Ultimately, given the extensive contractual relationship between you and [REDACTED] it is impossible to determine where [REDACTED] the service provider ends and [REDACTED] the stakeholder begins.

[REDACTED]

Additionally, you were formed, in part, for the purpose of benefiting [REDACTED] and its related construction company that constructing the housing development in which you will be located. You were created by [REDACTED] and share its directors. Because of your creation, [REDACTED] may not be required to pay educational impact fees to the County for future residents of the housing development. [REDACTED] can and does use you in its promotional materials to attract homebuyers to the development.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service

[REDACTED]
T:EO:RA:T:4, Room 3L3
1111 Constitution Ave, N.W.
Washington, D.C. 20224

[REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4